

WORKING PAPER

# **A Regulatory Analysis of the Specific Allocation Fund (DAK) and Horizontal Equalization in Indonesia**

Donald Feaver

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ALLOCATION FUND (DAK) AND HORIZONTAL  
EQUALIZATION IN INDONESIA**

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June 2008

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Feaver, Donald

A Regulatory Analysis of the Specific Allocation Fund (DAK) and Horizontal Equalization in Indonesia/Donald Feaver -- Jakarta: SMERU Research Institute, 2008.

iii, 21 p. ; 30 cm. -- (SMERU Working Paper, June 2008)

ISBN 978-979-3872-56-8

1. Decentralization and Regional Autonomy
2. Specific Allocation Fund

I. SMERU

352.12 / DDC 21



## ABSTRACT

### **A Regulatory Analysis of the Specific Allocation Fund (DAK) and Horizontal Equalization in Indonesia<sup>\*</sup>**

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This chapter examines the regulatory arrangements implemented by the Republic of Indonesia governing intergovernmental fiscal arrangements relating to specific funding allocations. The Specific Allocation Fund (DAK) is a statutorily created and governed policy instrument enabling the central government to make ‘specific’ fiscal transfers to regional and district governments that qualify for horizontal equalization assistance. The question that forms the basis of this chapter is whether the measures implemented to achieve DAK policy objectives constitute a coherent and operationally effective regulatory scheme. The mechanics and operational well functioning of the regulatory scheme are analyzed by examining the *regulatory coherence* of the statutory arrangements underlying the DAK. An outcome of this analysis includes consideration of the benefits of creating of a special administrative body to improve the functioning of the regulatory scheme.

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<sup>\*</sup> A background paper on the study “The Specific Allocation Fund (DAK): Mechanisms and Uses”, a joint study by The SMERU Research Institute and the Institute for Ethics, Governance and Law, Griffith University, funded by the Australia-Indonesia Governance Research Partnership (AIGRP)



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## I. OVERVIEW

The 2001 Indonesian ‘big-bang’ policies of decentralizing the delivery of public services and redistributing intergovernmental fiscal transfers are examples of the trend towards a ‘decentring’ of government that is occurring around the world. The decentring of government is defined as a re-allocation of governance functions and fiscal arrangements relating to the provision of public goods and services. Where public goods and services were previously supplied through highly bureaucratic and centralized governmental arrangements, the decentring process involves the transfer of public administrative responsibilities to more localized, and often specialized, decision-makers (Black 2001). The means by which the decentring process is coordinated, managed and controlled is through statutory instruments that employ a range of regulatory devices and techniques (including the use of specialist decision-making bodies) to implement policy objectives (de Mello and Barenstein 2001; Bardham 2002).

This chapter focuses on the regulatory mechanism implemented by the Republic of Indonesia governing intergovernmental fiscal arrangements relating to specific funding allocations. In Indonesia, the need for equitable and effective intergovernmental funding arrangements has arisen within the broader context of ‘big-bang’ decentralization in two respects. First, Indonesia is a unitary state in which the constitutional power to levy, collect, and allocate public revenue is controlled by the central government. In shifting public administrative responsibilities away from the central government to regional governments, intergovernmental fiscal arrangements have also had to be reformed to overcome the vertical funding imbalance among the different levels of central, regional, and local government (World Bank 2006). The second major fiscal challenge arises from horizontal differences in the levels of human and economic development that exist within and between different regions within Indonesia. It is this issue, and the regulatory mechanism implemented to address it, that is the particular focus of this chapter. The DAK is a statutorily created and governed policy instrument enabling the central government to make ‘specific’ fiscal transfers to regional and district governments that qualify for horizontal equalization assistance.<sup>1</sup>

The question that forms the basis of this chapter is whether the measures implemented to achieve DAK policy objectives constitute a coherent and operationally effective regulatory scheme. The mechanics and operational well functioning of the regulatory scheme are analyzed by examining the *regulatory coherence* of the statutory arrangements underlying the DAK. The coherence analysis is conducted across several dimensions. First, the DAK has quasi-constitutional characteristics that must be taken into consideration. The DAK does not exist within a legal vacuum and must conform to existing constitutional principles and limitations. Second, the policy objectives of the DAK are highly integrated with other fiscal transfer policies (i.e., vertical equalization and the General Allocation Fund (DAU)) and must operate in a manner that compliments broader fiscal policy objectives. Finally, the specific statutory instruments enacted to implement the DAK must conform to minimum standards of internal instrumental coherence evaluated against a test whether the regulatory framework is comprised of a

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<sup>1</sup>There is a great deal of research examining the policy underpinnings of intergovernmental fiscal arrangements. Vertical and horizontal equalization objectives are traditional motives for equalization schemes. It is not within the scope of this paper to examine the political and economic motives for implementing equalization schemes. For a review of the broad principles, see Bird (1993) and Ter-Minassian (1997).

relatively stable set of interrelated rules and incentives that constitute coherent procedures intended to achieve substantive goals (Weimer 1995).

To this end, the chapter is organized as follows. In Section 2, a brief overview of theoretical concepts and tools are reviewed. In particular, the notion of regulatory coherence is introduced and explained. In Section 3, a description of the structure and operation of the regulatory scheme as it now exists is undertaken. Section 4 builds on Section 3 by conducting an analysis of the regulatory coherence of the DAK conforming to the broad theoretical framework presented in Section 2. The coherence analysis conducted in Section 4 provides insight into certain mechanical weaknesses of the current DAK arrangements. A proposal with which to overcome these mechanical weaknesses through the creation of an administrative decision-making body having special powers is considered by examining the purpose and function of the Australian Government's Commonwealth Grants Commission. A brief summary and conclusion is included in Section 6.

## **II. RELEVANT THEORY: FISCAL RELATIONS, SUBSIDIARITY AND REGULATORY COHERENCE**

The regulatory coherence of the legislative scheme governing the allocation of the DAK is to be evaluated against the principle that: to have and maintain coherence and integrity; the purpose of law, the structure and function of legal systems, and the integrity of legal processes all must exhibit some degree of consistency and coherence. In a mechanistic sense, coherence can be described as an organizing principle that exhibits certain properties. The basic properties it exhibits emerge when it is used to evaluate the characteristics of linkages among and between abstract concepts. If a linkage of concepts or ideas is not coherent, the outcome will be a cognitive friction and conceptual instability.<sup>2</sup> This may be described as an incoherent outcome. If the linkage of ideas exhibits a more logical and functional interoperability among interrelated concepts, it is probable that more stable, predictable, and consistent outcomes will be achieved. Coherence, in brief, describes qualitative patterns in the arrangement of abstract ideas.

When applied to the analysis of regulation and regulatory schemes, coherence theory is closely related to the concept of regulatory failure. Although there is little agreement in the literature about what regulatory failure is or how it can be objectively recognized or explained (Lodge 2002), Breyer's classical legal definition of regulatory failure provides a useful starting principle. Breyer's definition states that regulatory schemes fail when *regulatory instruments are mismatched to the context in which they are applied* (Breyer 1983). Although broad, the definition implicitly identifies the requirement for consistency between the social problem underlying the need for a regulatory solution and the choice of regulatory machinery implemented to address that problem.

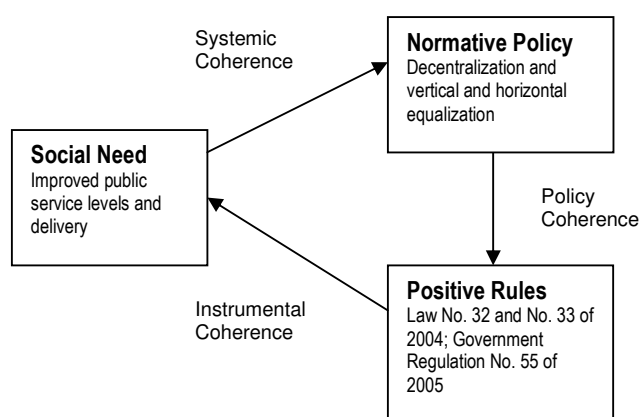
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<sup>2</sup>An idea common to all applications is the fundamental principle that a legal regime is more likely to generate incoherent outcomes if the relationship between the parts of the whole is not, conceptually, in alignment with components both of the legal system itself, but also with other social structures extending beyond the legal system (Balkin 1993).

To satisfy coherence requirements, a regulatory arrangement should exhibit three levels of regulatory coherence: systemic coherence, policy coherence, and instrumental coherence. Systemic coherence is an actual or ideal feature of a regulatory arrangement where its components fit together: either all of them (global systemic coherence) or some of them (local systemic coherence). Figure 1 illustrates how a regulatory arrangement is *systemically coherent* where the underlying social need for regulation and the normative policy foundations formulated to address that need are theoretically in alignment. In making the conceptual linkage between social need and normative policy, systemic coherence implies a requirement for a logical connection between the motivation for regulating (foundationalist approach) and the theoretical concepts that shapes a regulatory order (non-foundationalist approach) (Berteau 2005). This notion of a systemic coherence is also reflected in the constructivist ideal that regulatory institutions and rules are abstract social constructs created to serve the needs of a social order (or relevant suborders) in accordance with a particular social context. As the needs of societies and communities change, so too should the regulatory institutions and instruments that govern them (Prosser 1997). Regulatory policies that do not evolve and regulatory instruments that are not reformed to reflect systemic change will eventually fail in their regulatory objectives (Ayres and Braithwaite 1992).

The next level of regulatory coherence identified in Figure 1 is the requirement for alignment between the normative policy foundations and positive rules referred to as *policy coherence*. Policy coherence encompasses internal and external dimensions. Internal coherence is determined by whether the normative policy foundations are in alignment with policy choices embodied in the positive legal instruments formalizing the regulatory architecture. External coherence, also known as comparative coherence, has two subdimensions: within category and across category coherences (Sunstein et al. 2002). Within category coherence is defined as regulation that is consistent with other regulations of the same general type. Regulations are coherent across category where the overall pattern of regulations makes sense across different regulatory categories.

**Figure 1**



Finally, *instrumental coherence* reflects the positive dimension of regulation and is evaluated on the basis of whether the regulatory machinery, or means, chosen is consistent with and contributes to a *well-functioning* regulatory system. Regulation fails to make instrumental sense if its underlying social motives and normative policy foundations are not reflected in the positive instruments chosen and implemented. Instrumental incoherence arises where regulatory instruments (institutions and rules) are ineffectual, produce unintended consequences, or impose far too many costs relative to the social benefits they achieve (Coglianese 2002). Regulatory coherence, therefore, implies a consistency among all three dimensions of coherence.

However, the regulatory coherence of the DAK is more complicated than conventional regulatory schemes because of its quasi-constitutional characteristics.<sup>3</sup> The regulatory coherence of the DAK has two constitutional dimensions: one explicit, the other implicit (or extraconstitutional). The explicit constitutional provision that impacts upon the design and operation of the DAK is Article 18A (2) of the 1945 Constitution of the Republic of Indonesia which states that:

*The relations between the central government and regional authorities in finances, public services, and the use of natural and other resources shall be regulated and administered with justice and equity according to law.*

The implications of Article 18A (2) are evaluated within a coherence framework and are discussed in further detail in Section 5 below.

The second constitutional dimension of the DAK is derived from a source external to the Indonesian Constitution. In the absence of any explicit constitutional provision to the contrary, the extraconstitutional principle of subsidiarity (where it is possible for decisions to be taken at more than one level of government, decisions should be taken at the most decentralized level practicable) is becoming an increasingly accepted, but vague, guide as to the allocation of power (and funding) among different levels of government. Because of the breadth and generality of the subsidiarity principle, it can only be used to provide a guide as to the general contours of the coherence of DAK allocation arrangements. Even despite of its generality, subsidiarity is a useful principle in guiding statutory reform as discussed in Section 4 and Section 5.

### **III. THE STRUCTURE AND OPERATION OF THE REGULATORY SCHEME**

The structure and operation of the regulatory scheme relating to the DAK are relatively uncomplicated. In this section, the statutory architecture of the scheme is briefly described, highlighting its structure, composition, and administrative decision-making features. Certain aspects of the regulatory arrangement that are of particular relevance are identified and discussed.

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<sup>3</sup>Coherence can be used to analyze systems of law, the relationship between legal principles, or the linkage of ideas in the legal reasoning process. The theories and approaches can be divided into two broad types: structural theories of coherence which explain the linkage and interaction of parts of a legal regime (Dworkin 1986; Raz 1994); and the more mechanical, interpretive theories that focus on processes of legal reasoning and the linkage of arguments (McCormick 1984).

### 3.1 General Legislative Considerations

The DAK is one of several funding mechanisms designed to support the broader central government policy initiative of bureaucratic and fiscal decentralization. The DAK and all other funding mechanisms must conform (as previously noted) to the constitutional requirement of Article 18A (2) of the 1945 Constitution of the Republic of Indonesia which states that:

*The relations between the central government and regional authorities in finances, public services, and the use of natural and other resources shall be regulated and administered with justice and equity according to law.*

Article 18A (2) provides a constitutional principle, or boundary, that disciplines the several decentralized funding mechanisms enacted in Law No. 33 of 2004 concerning Fiscal Balance Between the Central Government and the Regional Governments (Law No. 33). Within this boundary, the purpose of these funding mechanisms is stated in the commencing Considerations of Law No. 33 as:

*That in support of regional autonomy through the provision of sources of financing based on the authority of the central government, decentralization, deconcentration, and co-administration, the sharing of revenues between the central government and the regional governments need to be clearly established in a financial system based on the sharing of authority, task, and responsibility among the government agencies.*

The importance of this Consideration is that it provides a policy directive setting out the broad principles underlying Law No. 33 relating to the ‘sharing of revenues’. How this revenue is to be shared is based upon ‘the sharing of authority, task and responsibility among the government agencies’. Further specificity is added through the general provisions in Article 1 (3) of Law No. 33, which provides that

*revenue sharing between the government and the regional governments means a fair, proportional, democratic, transparent, and efficient sharing of revenues in the financing of decentralization, deconcentration, and co-administration with due regard to the potential, condition, and need of the regions.*

The broad principles of revenue sharing (as it applies to all the funding mechanisms) contained in Law No. 33 are articulated in Article 2, which provides that

- (1) *revenue sharing between the government and the regional governments is a subsystem of the state finances as a consequence of the sharing of task between the government and the regional governments;*
- (2) *sources of state finances are made available to the regional governments in the implementation of decentralization based on the transfer of task by the central government to the regional governments with due regard to fiscal stability and fiscal balance; and*
- (3) *revenue sharing between the government and the regional governments is a comprehensive system in the funding of decentralization, deconcentration, and co-administration.*

Article 2 performs two important functions. First, Article 2 (1) clearly identifies the source of power and control as being retained within the jurisdiction of the central government in that the task of revenue sharing is deemed to be a ‘subsystem’ of central government finances. The importance of this provision is that there is *no delegation* of any administrative decision-making powers or authority to the regional governments (except where otherwise provided for explicitly by statute). The significance of this provision is discussed further in Section 4 and Section 5 below. Second, Article 2 (2) provides that state finances will be made available to the regional governments ‘having due regard to fiscal stability and fiscal balance’. Article 2 (2) is particularly relevant in relation to the DAK because it provides the statutory basis for ‘horizontally’ distinguishing between different regions on the basis of their fiscal circumstances. It, therefore, provides the statutory authority for creating the horizontal equalization mechanism that is described in Part Four of Law No. 33.

### 3.2 The Regulatory Framework of the DAK

The DAK is a specific allocation fund. As a regulatory device, its purpose is to address horizontal inequalities in financial capacity and levels of economic development between different regions within Indonesia. In effect, the fund is targeted towards providing central government funds to those regions that are deemed to need additional funding to bring the provision of public services (in seven key sectors) to a level that would not be possible without specific funding allocations. The total amount of DAK funding is set annually by the central government.<sup>4</sup> In the absence of provisions indicating how the size of the annual DAK allocation is to be determined, the composition of the DAK appears to be highly discretionary and is, therefore, subject to change from year to year having implications for regional planning and development initiatives.

The structure of the regulatory framework is parsimonious and broadly worded. Article 39 identifies and attaches the ‘specific’ status to the DAK by limiting its allocation to ‘certain’ regions as a ‘specific fund’. The main substantive provisions are contained in Article 40, which sets the broad eligibility criteria by providing that:<sup>5</sup>

- (1) *the government shall establish criteria for DAK, including general criteria, specific criteria, and technical criteria;*
- (2) *general criteria referred to in paragraph (1) shall be established with due regard to the financial capacity of the region in APBD;*
- (3) *specific criteria referred to in paragraph (1) shall be established with due regard to the prevailing laws and regulations and the characteristics of the region; and*
- (4) *technical criteria referred to in paragraph (1) shall be established by the state ministry/ technical department.*

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<sup>4</sup> See Article 38 of Law No. 33, which provides that the amount of the Specific Allocation Fund (DAK) shall be established annually in APBN (the national budget).

<sup>5</sup> See also Article 41 of Law No. 33, which provides that (1) all regions receiving the DAK shall provide co-funding in an amount of at least 10% (ten percent) of the DAK allocation; (2) co-funding referred to in paragraph (1) shall be budgeted in APBD (the regional budget); and (3) a region with a certain fiscal capacity shall not be required to provide co-funding.

The lack of prescription in Article 40 is to be addressed through regulations made by the central government.<sup>6</sup> The relevant regulation that is now in force is Government Regulation No. 55 of 2005 regarding Balance Funds (Government Regulation No. 55). Government Regulation No. 55 is significant in that it allocates the responsibility of administering functions relating to the financial management of the DAK to the Minister of Finance. More significantly, Article 54 (3) of Government Regulation No. 55 provides insight into the mechanics of how the fund is to be calculated and allocated:

*Besaran alokasi DAK masing-masing daerah sebagaimana dimaksud pada ayat (1) huruf b ditentukan dengan perhitungan indeks berdasarkan kriteria umum, kriteria khusus, dan kriteria teknis.*

*[The DAK grant referred to in paragraph (1) (of Article 54) is determined with the calculation of an index based on the general criteria, the specific criteria, and the technical criteria.]*

The rough English translation of Article 54 (3) of Government Regulation No. 55 of 2005 refers to the method of allocation of the DAK as being based on the calculation of an index (or formula) derived from the general, specific, and technical criteria referred to in Article 40 of Law No. 33 of 2004. The construction, calculation, and administration of the allocation formula are the substantive core of the regulatory arrangement and, accordingly, warrant special attention. It is important to note that the administrative authority to construct and apply the formula in the course of DAK allocation falls within the scope of responsibility of the Ministry of Finance with the input and assistance of other relevant Ministries. Government Regulation No. 55 of 2005 provides a general procedural roadmap indicating which relevant government ministries are expected to contribute required statistical information to enable the Ministry of Finance to apply the formula constructed to guide DAK allocation.

### **3.3 Core Regulatory Composition: The Eligibility Test**

The substantive core of the regulatory scheme is the method (and formula-based regulatory mechanism) by which eligibility for the DAK is calculated and tested. The basis, but not detailed explanation, of the formula is contained in Government Regulation No. 55 of 2005. Government Regulation No. 55, however, only directs the use of certain indices as part of the formula's composition. The Ministry of Finance conducts the construction and application of the formula that is actually used. The essential feature of a formula allocation program such as the DAK is that the amounts to be allocated are determined by a formula that uses statistical information to calculate or estimate the values of its inputs, and these are processed to produce outputs. Often, the allocation process consists of a basic calculation using a mathematical formula or algorithm, followed by adjustments that place constraints on levels or shares (percentages of the total allocation) or on changes in levels or shares.

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<sup>6</sup>See Article 42 of Law No. 33, which provides that further provisions on the DAK shall be established by government regulations.

## The Formula and its Calculation

**Step 1:** The determination whether a district/city is eligible to receive the DAK under the general criteria provisions of Law No. 33 is derived from Net Fiscal Index (NFI)  $NFI < 1$ ;

**Step 2:** If a district/city does not fulfill the general criteria; whether the city/district falls within a special autonomy region (districts/cities within the Provinces of Aceh and Papua). If yes, the district/city is eligible to receive the DAK;

**Step 3:** If a district/city is not under the territory of the provinces of Aceh or Papua, it may qualify for DAK funding under the specific criteria provisions. A city/district that satisfies the specific criteria requirements include coastal and offshore areas, areas bordering a foreign country, remote areas, and areas prone to floods and landslides, and food shortages. The specific criteria characteristics of such a city/district is calculated and reflected by the Regional Characteristic Index (RCI);

**Step 4:** Combine NFI and RCI to generate a composite Fiscal and Regional Index (FRI);

**Step 5:** If a district/city has an FRI calculation less than 1, then the respective district/city is automatically eligible to receive DAK (although, initially based on Step 1, is not eligible to receive DAK). Conversely, if the respective district/city has FRI greater than 1, then it will not be eligible to receive DAK;

**Step 6:** Districts/cities that are eligible to receive DAK are districts/cities that fulfill Step 1 (where  $NFI < 1$ ); or fulfill Step 2 (districts/cities under the territories of the provinces of Aceh or Papua, no matter their  $NFI > 1$  or  $NFI < 1$ ); or fulfill Step 5 where their  $FRI < 1$ ;

**Step 7:** For all districts/cities which are eligible based on Step 6, the calculation  $FRI = f(NFI, RCI)$  must be made;

**Step 8:** A weight of region (WR) calculation is made by multiplying the local FRI and Construction Cost Index (CCI);

**Step 9:** For all eligible districts/cities, a Technical Index (TI) is calculated for each sector that will be given DAK;

**Step 10:** A calculation of the Technical Weight (TW) is conducted by multiplying the Technical Index (TI) and Construction Cost Index (CCI);

**Step 11:** The determination of DAK weight is derived from the result of addition of Weight of Region (WR) and Technical Index (TI);

**Step 12:** The Weight of DAK determines the amount of each individual district/city's DAK.



## IV. REGULATORY COHERENCE ANALYSIS

In this section, an analysis of the regulatory coherence of the DAK allocation arrangements described in Section 3 is conducted conforming to the theoretical framework presented in Section 2. The three dimensions of regulatory coherence are discussed in the subsections that follow, beginning with an analysis of the systemic coherence of the regulatory scheme. This is followed by a brief analysis of policy coherence. Finally, and most importantly, emphasis is placed on an analysis of the instrumental coherence of the scheme including its structure, composition, and administrative decision-making features.

### 4.1 Systemic Coherence

The systemic coherence of the regulatory mechanics of the DAK allocation scheme is evaluated within the context of two general parameters. One parameter is the consistency of the regulatory scheme's objectives and functions with the normative social need (being the underlying justification) for regulatory intervention (Baldwin and Caves 1999). A second general parameter is any constitutional boundaries or constraints (principles) that impose limits on the design and operation of the regulatory scheme. Both parameters represent underlying and pervasive systemic forces that impact upon the DAK's coherence as a well-functioning regulatory scheme. The concept of systemic coherence is derived from the principle that all regulatory schemes are regulatory systems that are embedded within, and can therefore only achieve their regulatory objectives if they bear an intersystemic coherence and consistency with, the larger socio-legal system within which they operate (Balkin 1993).

The normative social need for the creation of the DAK is motivated by the requirement for a regulatory device that, consistent with the twin policy objectives of decentralization and deconcentration, provides a horizontal equalization mechanism to improve human welfare in the more disadvantaged regions of Indonesia. Implicit in the normative objective is the assumption that equalization may require an unequal, and hence 'specific', distribution of funding to regions that have a greater financial need than others. In this context, the DAK appears to be systemically coherent in that its regulatory objectives are consistent with its underlying normative rational.

The analysis, however, becomes more problematic where the normative basis of the scheme is analyzed relative to the existing constitutional boundaries: in particular, Article 18A of the Constitution. The question is whether there is consistency between the general principles of Article 18A of the Constitution and the specific purpose and function of the DAK. Given that Article 18A makes it a constitutional requirement that fiscal measures 'be regulated and administered with justice and equity according to law', the definition of 'equitable' in this context is of particular importance. In effect, to be systemically coherent, the regulatory mechanism underlying the DAK must satisfy the requirements of what constitutes 'equitable' within the meaning of the law.

'Equitable' has slightly different meanings in law and economics. If a legal definition of equitable is followed, equity has traditionally been used within common law countries to achieve distributive fairness and natural justice. It is a term that, in a legal context, has historically meant the taking of measures to achieve a just outcome to ensure that the law accords equal treatment of equal or similar parties. Equality runs counter to the concept

of an unequal distribution of funding and hence, the concept of specific funding that may result in an unequal allocation. Read in this sense, the DAK, it can be argued, is not only incoherent in a regulatory context, but also could be unconstitutional as violating Article 18A if the DAK allocation method is deemed, for some reasons, not to be equitable (Elkins 2006).

The alternative view is that a purely legal reading of Article 18A ignores its legislative and technical contexts (Buchanan 1950). Given that Article 18A (2) is related to public finance, it is logical that a definition of equity drawn from welfare economics was intended by the constitutional drafters, or should apply.<sup>7</sup> In welfare economics, the term equitable does not mean proportional; it has been taken to mean, since the rise of the welfare state in the post WW II world, ‘what a given society deems appropriate to the need, status, and contribution of a society’s members’ (Young 1994). The large body of literature linking notions of fiscal equity with broader concepts of social justice has long been accepted as a legitimate basis for horizontal equalization schemes. However, it should be noted that in recent years, the equity/equality debate in relation to horizontal equalization schemes has become the subject of increasing scrutiny (particularly in a constitutional context in the United States) (Elkins 2006).

## 4.2 Policy Coherence and Horizontal Equalization

As mentioned in Section 2, the policy coherence of a regulatory scheme implies that the policy under review is externally consistent with other interrelated policies as well as internally consistent with the regulatory mechanisms chosen to implement the policy. Policy consistency in relation to fiscal transfer mechanisms, in general, and the DAK, in particular, is closely related to the combined policy objectives of vertical and horizontal equalizations. In spite of the increasing scrutiny of horizontal equalization schemes, there is an acceptance around the world that both horizontal and vertical fiscal transfer mechanisms are legitimate and necessary components of fiscal policy (OECD 2007).

Both vertical and horizontal equalizations are fundamental regulatory components of Law No. 33 of 2004. However, it is clear from reading the Considerations preceding the substantive provisions of Law No. 33 that the law’s policy emphasis is directed towards vertical equalization with little or no specific mention of the importance of and need for horizontal equalization mechanisms. Although this is not fatal in practical terms and does not unduly affect the functioning of the horizontal equalization mechanism, the absence of a policy statement appears contrary to the increasing importance of the DAK in terms of its growth in budgetary size as well as its important function.

In practical terms, Law No. 33 has three policy objectives. However, when the general policy objectives contained in the Considerations of Law No. 33 of 2004 are deconstructed, only two policy objectives can be identified as being specified. The first, and most broad, is that Law No. 33 of 2004 is a comprehensive enactment governing a range of fiscal measures aligned with the political/institutional decentralization and deconcentration initiatives of the ‘big-bang’ decentralization policy. The second, more specific policy objective is directed towards vertical equalization through the statement of a general policy principle intended to apply to the several different funding mechanisms contained in Law No. 33 (such as the DAU, DBH, or the Shared Revenue Fund, and

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<sup>7</sup>It should be noted that Article 18A (2) is a recent constitutional amendment made at or around the time of the decentralization initiatives.

loan facilities). As a consequence, there is no clear policy prescription that applies specifically to the DAK.

The third policy objective of horizontal equalization, therefore, is not mentioned in the Considerations preceding the substantive provisions of Law No. 33. Of all the funding mechanisms contained in Law No. 33, the DAK in particular warrants specific policy consideration and statutory mention (useful for the purposes of interpretation in the event of legal challenge) because of its exceptional status and function. The absence of a general policy prescription for the purpose and function of the DAK within the broader policy context of Law No. 33 produces a logical inconsistency between the general policy principles of Law No. 33 and the exceptional purpose of the DAK. Because the DAK is not a fund to be allocated on the basis of equitable proportionality and, arguably, serves a broader policy function than merely as a ‘topping up’ fund available to the most disadvantaged regions, both the absence of a specific mention in the Considerations and relative lack of prescription of the substantive provisions (discussed in greater detail below) regarding the DAK contained in Law No. 33 lead to the outcome of some degree (though far from disabling) of policy incoherence.

### 4.3 Instrumental Coherence

Minimum standards of internal instrumental coherence are evaluated against a test whether the regulatory framework is comprised of a relatively stable set of interrelated rules and incentives that constitute coherent procedures intended to achieve substantive goals (March and Olsen 1996). More succinctly, the question is whether the regulatory machinery (the means and techniques chosen to implement the policy) contributes to a *well-functioning* regulatory system. A regulatory scheme fails to be instrumentally coherent if its underlying social motives and normative policy foundations are not reflected in the positive instruments chosen and implemented. In addition, instrumental incoherence can arise where regulatory instruments (institutions and rules) are vague and ineffectual, produce unintended consequences, or impose far too many costs relative to the social benefits they achieve (Coglianese 2002). Instrumental coherence is evaluated by examining

- the *structural characteristics*, consistency, and transparency of the regulatory scheme;
- the *substantive composition* being completeness and effectiveness of the principal rules which form the core of the regulatory scheme; and
- the *administrative coherence* of the critical decision-making powers allocated within the statutory framework to the main administrative decision-makers, including how those powers are exercised.

### Structural Coherence

The basic structural characteristics of a regulatory scheme are determined by its type (or technique), its organizational/institutional characteristics, and the legal relationship between the actors involved and affected by the scheme. Different regulatory techniques utilize different methods to both discipline actors and encourage compliance with a particular scheme. For example, compliance may be achieved through cooperation, consensus, incentive, or the use of coercive authority (Morgan and Yeung 2006). The most appropriate and effective regulatory model chosen will be dictated by the circumstances giving rise to its need (Mitnick 1980; J.Q. Wilson 1982; Breyer 1982; Ogus 2002).

The regulatory type (or technique) that best describes the regulatory scheme underlying the DAK is a traditional command and control model using a formula-based funding allocation method (commonly known as formula-based regulation (FBR)) (Downes and Pogue 2002). The vast majority of the administrative and specialist decision-making functions that attach to the scheme are held and exercised by ministries. Although regional and district governments are the targeted beneficiaries of the scheme, the main actors responsible for carrying out functions under the scheme are agencies and authorities at the central level. Finally, the structure of a regulatory scheme is partially determined by the institutional and instrumental forms that are created to implement the scheme.

There appear to be several issues relating to the structural coherence of the regulatory scheme. Upon reading Law No. 33 of 2004 and Government Regulation No. 55 of 2005, it is not entirely clear, in terms of a coordination of statutorily directed functions, what tasks must be conducted by various ministries. Although the Ministry of Finance is ultimately responsible for the overall administration of the scheme, there is no clear directive as to what its specific functions in relation to the scheme are and, as a result, there is no clear chain of authority among and between other relevant ministries. Hence, there is a problem of transparency.

A second structural consideration relates to contemporary perspectives on what constitutes good regulation and the constitutional issue of subsidiarity. As part of a move away from command and control regulation in preference of more consensus-oriented techniques, the importance of the role of all stakeholders in the regulatory process, including those being regulated or who are the beneficiary of the regulation, is increasingly being recognized (Ayres and Braithwaite 1992). Greater stakeholder participation (being participation by district and regional governments) in the policy-making and management functions of the DAK would further two objectives. First, it conforms to contemporary concepts of what constitutes good regulatory design where better information flow and administrative decision-making is gained through better stakeholder interaction. Second, better stakeholder participation on the part of district and regional governments accords with the extraconstitutional principle of subsidiarity also improving the distribution of information, inputs, and functions among all levels of government in the regulatory scheme. Given that the regional and district governments have only a minor role to play in the administration of the scheme, the imbalance in stakeholder involvement may be considered a source of potential structural incoherence.

### **Compositional Coherence**

The compositional coherence of a regulatory scheme is evaluated by examining whether the substantive provisions provide sufficient and clear directives that, if carried out as required, produce the intended regulatory outcome. The main compositional provisions of the DAK are contained in Articles 39–42 of Law No. 33 of 2004. As mentioned above, the Articles are not highly prescriptive providing that DAK allocations are to be made according to vague eligibility criteria. The lack of prescription as to eligibility criteria and complete absence of clear procedural rules as to how to apply for DAK and less than clear rules relating to the administration of the scheme raise questions relating to transparency and accessibility issues underlying the regulatory process.

However, the general Articles 39–42 of Law No. 33 of 2004 are supplemented and expanded upon by Articles 51–58 of Government Regulation No. 55. The absence of clear eligibility requirements in Law No. 33 are partially overcome through the inclusion of the index-driven formula (index-based calculation) authorized by Government Regulation No. 55. However, in mandating the use of the index-based calculation as the sole basis for testing DAK eligibility, the distribution of the fund is entirely determined by statistical data reflecting the relative difference across the regions and districts. Although it does not represent compositional incoherence in its own right, the complete reliance on a statistical formula as the only allocation mechanism risks producing incoherent outcomes. This, for example, can arise where the nature of the data used to apply the eligibility formula is insufficiently sensitive to capture particular population pockets or community groups that should otherwise be eligible for DAK funding. Conversely, misallocations due to statistical variation or inherent bias in formula inputs may result in regions that would not be eligible and can result in a channelling of resources away from their intended purpose.

Formula-driven regulation is not uncommon where a bureaucratic arm of government is charged with the responsibility of managing a regulatory process. The application of a formula removes the need to grant special discretionary decision-making powers to the bureaucratic administrator. Formula-based regulation can work effectively but also has two major drawbacks. First, the formula may not work equitably in all circumstances resulting in exceptional cases of ‘falling between cracks’ as well as other funding misallocation problems. Second, (as is the case with the DAK scheme) bureaucratic decision-makers are not granted the authority to correct for the administrative rigidity and inflexibility of the formula and frequently do not have the discretionary powers to override inequitable outcomes without special intervention by a minister or the legislature.

Neither Law No. 33 nor Government Regulation No. 55 appears to provide much prescription or direction in the decision on the basic formula to be used, the more specific variables (e.g., population size, tax revenue, per capita income), the formula components, and the statistical data series to be used to calculate or estimate their values. Given that the formula does exist and is being maintained and utilized by the Ministry of Finance, the absence of a monitoring and oversight mechanism is a potential source of regulatory failure.

### **Administrative Coherence**

As mentioned above, one of the purposes in implementing formula-based regulatory arrangements is that it reduces the need for legislators to transfer discretionary decision-making powers to regulatory administrators. Given that the core substantive provisions of the DAK are dealt with through a formula-based arrangement, most administrative considerations are related to the creation, maintenance, and application of the formula. The responsibility for the creation, maintenance, and application of the formula lies with the Ministry of Finance. Although not explicitly stated in either Law No. 33 or Government Regulation No. 55, the Ministry of Finance has been administering the DAK allocation mechanism through what appears to be an implied authority to create, improve, and apply the index-based calculation referred to in Government Regulation No. 55. The question whether it is administered in a manner that satisfies the requirements of regulatory coherence is discussed further below. The rigid funding allocation mechanism underlying the DAK is not necessarily inappropriate, is institutionally unsupported, and is potentially inequitable in its rigidity and inflexibility.

## **V. THE REGULATORY NEED FOR A SPECIAL ADMINISTRATIVE BODY TO ADMINISTER THE DAK**

An outcome of the preceding analysis of the regulatory mechanism underlying DAK allocation is functionally coherent in spite of the regulatory scheme's lack of prescription and the rigidity of formula-based regulation. However, even though the scheme appears to be functioning at present, there is a strong likelihood that the scheme may encounter a whole range of problems in the future arising from the weaknesses and rigidity of its design. Given the importance of the regulatory scheme (both in its own right and in combination with the DAU allocation regulation), it is timely to consider the creation of a specialized administrative body to perform a range of tasks relating to both DAK- and DAU-related fiscal transfer issues. Both the DAK and DAU are formula-based regulatory arrangements. Both involve an effective trade-off between political control, on the one hand, and expertise in developing, applying, and monitoring formula-based regulation in a transparent, equitable manner on the other. As has been done already elsewhere around the world, legislators should consider giving greater flexibility and powers to program agencies including:

- i) powers to overcome the potential misallocation and unforeseen inequities of funding allocation formulas including special powers to make exceptional recommendations;
- ii) powers to alter, amend, revise, upgrade, and maintain the formula;
- iii) a mechanism to enable better representation of the different stakeholders in the formula determination and (possibly) application process; and
- iv) mechanisms that institute formal oversight and monitoring mechanisms.

Some insight into the design and functions of an Indonesian agency created to be responsible for critical fiscal transfer-related issues and questions can be gained by examining the role and operation of the Australian Government's Commonwealth Grants Commission (the Commission).

### **5.1 The Commonwealth Grants Commission as a Model**

The issue of specific grants and problems related to their allocation identified in the previous section have several direct parallels to similar issues encountered in Australian public financial history (Hancock and Smith 2001). Following a series of fiscal crises after Federation in 1901, chronic issues relating to specific funding arrangements led the Australian Government to establish the Commonwealth Grants Commission in 1933.<sup>8</sup> The Grants Commission was, in part, an institutional response to the political instability and tension between the states and Commonwealth Government arising from difficult economic conditions caused by the Depression. In addition, it was also evident that differences in economic development meant that the fiscal capacity between the states was not converging.

Early in its operational history, the Commission recognized the need to find a 'principle' that could be applied with consistency to the various circumstances of the different states. "The difficulties of measuring 'disabilities' and the differences between states in the nature of their claims for specific assistance also underscored the need for the Commission to develop an approach which was flexible, seemed objective, and was at

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<sup>8</sup>Commonwealth Grants Commission Act 1973

the same time more practical than attempting to place a money value on the ‘net disabilities from federation’” (Hancock and Smith 2001). These characteristics were found in the principle of ‘fiscal need’, described by Head (1967), as ‘*an ingenious reconciliation of the diverse arguments in a principle of financial equality*’. The guiding principle employed by the Commission in making its assessments for specific grants had been unchanged since its adoption in 1936.

The scope of the Commission’s jurisdiction is narrow. First, the Commission’s jurisdiction extends only to issues relating to horizontal, not vertical, equalization. Therefore, it is restricted to acting in relation to specific funding requests and issues rather than playing a more substantive role in Australian fiscal arrangements. Second, the Commission functions an *advisory body* that responds to terms of reference from the Minister for Finance and Administration made pursuant to Section 16 of the Commonwealth Grants Commission Act and has no authority to initiate action on its own accord (Morris 2002). In this context, the Act provides that “the Commission shall inquire into and report to the Minister upon:

- (a) *any application made by a state for the grant, under Section 96 of the Constitution, of specific assistance to the state;*
- (b) *any matters, being matters relating to a grant of assistance made under that section to a state either before or after the commencement of this Act, that are referred to the Commission by the Minister; and*
- (c) *any matters, being matters relating to the making of a grant of assistance under that section to a state, that are referred to the Commission by the Minister.”*

These are generally requests for calculating appropriate ratios of per capita grants for distributing general revenue assistance from the Commonwealth Government to the states and territories. The details of these references are usually negotiated between the Commonwealth, state, and territory treasury departments before being formally issued by the Commonwealth Minister for Finance and Administration. The Commission reports to the Commonwealth Government and immediately after provides copies to the states and territories. The Commission's recommendations are then considered at the annual meetings of the Treasurers of the Commonwealth, state, and territory. For example, the terms of reference for the 2004 Review of State Revenue Sharing Relativities required the Commission to review the methods used to determine the per capita relativities for distribution of GST (Goods and Services Tax) revenue and healthcare grants. The nature of the work was more mechanical than conceptual directed to improving the existing principles of equalization (including specification of the equalization model used to assess relativities) (Morris 2002; Commonwealth Grants Commission 2004).

The Commission performs an important role in Australian Commonwealth/state fiscal relations. However, it has been developed over time to respond to issues associated with Australian fiscal federalism. Although it provides insight into how a similar administrative decision-making body may make a vital contribution to improving Indonesian fiscal arrangements, the Commission does not provide a model that can be directly transposed.

## 5.2 The Indonesian Model

The circumstances underlying fiscal equalization arrangements differ between countries. Unlike Australia, which is a federal state, the Republic of Indonesia has a unitary constitutional structure. This structural difference affects the distribution of taxation and spending powers among different levels of government, which in the case of Indonesia, is heavily weighted in favour of the central government. The more centralized Indonesian structure is reflected in the close interconnection among the vertical and horizontal equalization mechanisms contained in Law No. 33 of 2004. In addition to a closer regulatory nexus between horizontal (DAK) and vertical (DAU) fiscal equalization mechanisms, Indonesian law (unlike Australian law) prescribes a formula-based approach to both DAU and DAK funding allocations. Although funding allocation formulas are used in Australia, horizontal equalization formulas are not statutorily mandated and are used as technical tools to assist in allocation determination.

These two key structural and compositional differences provide sound reasons for the creation of a special administrative body to oversee the governance of Law No. 33 of 2004. In addition, they also provide the basis for granting a special administrative body powers that are jurisdictionally broader and discretionarily deeper than that of the Australian Grants Commission. Finally, the creation of a special administrative body provides an opportunity to address potential regulatory incoherencies inherent in the present structure and composition of Law No. 33 thereby overcoming a range of potential regulatory problems described in previous sections of the chapter.

The creation of a special administrative body that is statutorily independent of the Ministry of Finance provides several structural and compositional benefits that could improve the functioning of the regulatory arrangements. First, the creation of a special administrative body made up of representatives from the central government and the regional and district governments provides an opportunity to overcome structural issues relating to stakeholder participation. By having the various levels of government represented within the administrative body, a better balance of political interests, conceptual perspectives, and information exchange can be achieved. Improved stakeholder participation through administrative representation also increases the legitimacy and transparency of the regulatory scheme.

Unlike the Commonwealth Grants Commission, which has no oversight function, the compositional coherence of Indonesian fiscal relations would be improved should a special administrative body be granted oversight functions. Oversight responsibilities have the obvious benefit of correcting or improving transparency and coordination. In addition, regulatory oversight can play an important role in bringing procedural discipline to the collection and coordination of information, meeting of timelines, and general conduct of regulatory tasks. Finally, the most important oversight function to be performed would be to oversee the administration of the formula-based regulation applied by the Ministry of Finance.

The most critical compositional role of a special administrative body would be to take responsibility for the maintenance and amendment of the formula-based regulation. A special administrative body is well-suited to becoming a repository of expertise relating to the design, construction, and reform of the formula-based regulation. An assignment of that function would require the delegation of sufficient powers to make changes to the formula (within limited scope) on an ongoing basis. In addition, the administrative body



should be granted the authority to act upon special references by the central government (or regional governments) in relation to issues relating to the formula-based regulation.

In order to carry out its duties, the administrative body would require a greater set of discretionary decision-making powers than those presently contained in Law No. 33. The necessary powers would ideally include discretionary powers to make or amend procedural aspects such as the application process, discretionary powers to make procedural changes to the formula calculation process for purposes of transparency, discretionary powers to make non-formula driven adjustments where application of the formula produce incoherent outcomes. Finally, the administrative body should be given the responsibility of an advisory body similar to that of the Commonwealth Grants Commission. In its role as an advisory body, it would be responsible for investigating and studying alternative methodologies in fiscal equalization, investigating specific issues arising from emergency funding needs, and investigating changing economic and policy conditions underlying fiscal equalization.

## **VI. SUMMARY AND CONCLUSION**

The regulatory arrangements relating to specific funding allocations governing intergovernmental fiscal arrangements in Indonesia are new. The regulatory scheme is controlled and administered by the central government and is based upon a traditional command and control regulatory approach having very little external stakeholder involvement and participation in the regulatory process. A core compositional element of the regulatory scheme is the funding allocation mechanism that is derived from index-driven formulas developed and applied by the Ministry of Finance. The basic regulatory arrangement is formalized in Law No. 33 of 2004. Law No. 33 contains a broad regulatory framework and lacks necessary prescription. This lack of prescription is to be overcome through the enactment of central government regulations from time to time (such as Government Regulation No. 55 of 2005).

An analysis of the regulatory coherence of the scheme examines its systemic, policy, and instrumental linkages to determine the consistency, integrity, and transparency of the regulatory scheme. At this stage in the DAK's history, it appears that the broad regulatory framework is sufficiently coherent to enable the regulatory scheme to function. However, the analysis identifies how the scheme has several structural, compositional/substantive, and administrative weaknesses that are likely to hinder the scheme and undermine its coherence and operation effectiveness in the future.

The main structural weakness is an imbalance in stakeholder participation. This imbalance has systemic and functional implications. Systemically, the structure of the regulatory scheme can be seen as contrary to the subsidiarity principle where the design of the regulatory arrangement does not reflect a decentralization process that is as extensive as it should be. Functionally, this systemic imbalance is reflected in an imbalance in stakeholder participation, which can affect the operation of the scheme. A second structural weakness is a lack of coordinative and procedural prescription. This weakness gives rise to transparency issues relating to the application, allocation, and execution of tasks and functions relating to the administration of the scheme.

The core compositional feature of the scheme is an index-driven funding allocation mechanism. Formula-based regulation often involves the design, construction, and maintenance of complex formulas. These tasks require extensive specialist expertise as well as a complex balance between administrative authority to develop and apply the formula, on the one hand, and both political latitude and oversight on the other. Finally, formula development should also involve the input and consensus of affected stakeholders. To achieve this balance, the delegation of greater administrative powers may be required. The delegating of authority to non-legislative decision-makers, in itself, requires careful consideration to achieve a balanced regulatory design.

One means by which many of these issues may be resolved is through the creation of a special administrative body set at arms-length from the Ministry of Finance. Proper design of such a body provides an opportunity to overcome structural, compositional, and administrative concerns with the present scheme. The Australian Commonwealth Grants Commission provides an example of such a body and how it is able to contribute to improving intergovernmental fiscal relations. However, in the Indonesian context, the jurisdictional scope and discretionary depth of powers and functions exercised by such a special authority need to be more comprehensive.

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